

Action
OCA 86-2010

Legislation

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	ACTION	INFO
1. D/OCA		X
2. DD/Legislation		X
3. DD/Senate Affairs		X
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5. DD/House Affairs		X
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7. Admin Officer		
8. Executive Officer		X
9. FOIA Officer		
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SUSPENSE 16 June 86
Date

Action Officer:

Remarks: *Completed when notified
John Encheta at OMB, no objection
to testing / full on trade*

GJ / 12 June 86

Name/Date

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CONGRESSIONAL AFFAIRS

86-2010



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

June 11, 1986

SPECIALLEGISLATIVE REFERRAL MEMORANDUM

OOA FILE *leg. liaison*
RECPT # Chrono

TO: Legislative Liaison Officer-

Department of the Treasury (Carro 566-8523)	28
Department of Defense (Windus 697-1398)	06
Department of State (Berkenbile 647-4463)	25
National Security Council	
Central Intelligence Agency	
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Federal Emergency Management Agency (Perry 646-4105)	10
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SUBJECT: Commerce draft testimony on offsets for June 18, 1986, hearing.

The Office of Management and Budget requests the views of your agency on the above subject before advising on its relationship to the program of the President, in accordance with OMB Circular A-19.

A response to this request for your views is needed no later than NOON, MONDAY, JUNE 16, 1986.

Questions should be referred to JOHN EISENHOUR (395-3920), or to TONY CHAVEZ (395-3664).

Randy Coleman for

RONALD K. PETERSON FOR
Assistant Director for
Legislative Reference

Enclosures

cc: Al Burman
F. Picoult

SPECIAL

STATEMENT OF DR. PAUL FREEDENBERG
ASSISTANT SECRETARY FOR TRADE ADMINISTRATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
JUNE ¹² 5, 1986

Good Morning. Mr. Chairman, I am pleased to have the opportunity to appear before the Subcommittee on Economic Stabilization to discuss the DPA 309 report on military offsets.

The study's interagency coordinating committee, chaired by the Office of Management and Budget, recently submitted to your committee an analysis of the impact of offsets on U.S. defense preparedness, industrial competitiveness, employment and trade. As you know, the Commerce Department was assigned lead responsibility in preparing the chapter evaluating the impacts of offsets on industrial competitiveness. Commerce also was active in designing the offsets survey questionnaire for U.S. industry.

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In developing our chapter, the Commerce Department relied extensively on the aggregated industry survey data provided by the International Trade Commission through the Office of Management and Budget. The International Trade Commission survey on offsets provided the first aggregate base of data on the frequency and extent of offsets in U.S. defense industry export trade during the 1980-1984 time period. The survey covered approximately 140 firms, primarily aerospace prime contractors in the defense industrial base. The study focused on the aerospace industry as it is the dominant sector in the U.S. defense industrial base, representing approximately 50 percent of the dollar value of DOD purchases of manufactured products and 70 percent of U.S. defense hardware exports. Survey coverage of the U.S. aerospace industry was extensive and these firms encompassed the majority (in terms of dollar values) of U.S. military export trade involving offsets.

Commerce Department analysis of the results of the ITC survey support several broad observations:

- o Offsets are a major influence in military export trade, involving over \$22.4 billion in sales agreements as reported by the companies surveyed in the period 1980-1984.
- o Over 75 percent of all military offset obligations incurred are to the highly industrialized nations.

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- o The majority of all military offset obligations - over \$9 billion of the \$12.4 billion reported - were incurred by industries of the U.S. aerospace sector.
- o Almost 40 percent of all military offset obligations are to be fulfilled in the form of coproduction, licensed production, direct subcontracting and technology transfer.

To supplement the ITC data in developing our chapter, my staff also requested offsets information from 26 Department of Commerce, U.S. Foreign Commercial Service Posts. The 26 posts queried included all of NATO Europe, Canada, Japan, Australia, as well as other friends and allies of the United States. In analyzing the cable responses from our posts, we discovered several trends in foreign government policies concerning offset trade: ✓

- o Military offsets have increasingly become a central factor in awarding military contracts.
- o The range and magnitude of offsets demanded has increased significantly in the last five years.
- o The nature of military offsets demanded has increasingly tended toward arrangements which include targeted technology transfer and production/management know-how.

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- o The technology obtained has often been applicable to commercial industries selected by the purchasing government for growth and development.
- o Foreign governments have begun to codify official policies and procedures concerning offsets in military trade.

Foreign governments are increasingly using the offset concept as a tool of trade management. Most foreign purchasing governments devote significantly less money (as a percentage of GNP) to defense than the U.S. does. Therefore, they try to obtain maximum leverage from offset agreements in order to minimize foreign exchange outlays for costly defense system purchases. The trend on the part of foreign purchasing governments is to use offsets to override competitive advantages of other foreign industries, encourage growth in targeted industries, and increase their standard of living. Offsets are also used to assist developing export industries to target desirable export markets, including the U.S. defense base. The rise in government managed trade has also led to increased competition and protectionism in U.S. export markets.

What are the benefits and costs associated with military offsets? Analysis of the ITC industry data, the DOC cables and other collateral sources indicates that offsets have a mixed impact on

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U.S. industrial competitiveness. The correlations that may be drawn between offsets and potential positive and negative impacts on U.S. industrial competitiveness are by no means exact, but analysis of available data and literature supports several observations on the effects of offsets. These include:

- o To the extent that military offsets enable U.S. defense contractors to achieve export sales that would not be possible if we refused to offer offsets, they have made a positive contribution to the marginal income of U.S. defense contractors.
- o Direct offsets, in the form of coproduction, licensed production, direct subcontracting and technology transfers, contribute to the competitiveness of foreign producing nations and may have a negative effect on many sectors of the U.S. defense industrial base. However, increased competition can result in lower costs for defense production.
- o The principal cost of increasing direct offset concessions could be a loss in market share for U.S. subcontractors. The majority of direct offsets according to the ITC data were in the area of electronics, aircraft parts and engine parts - industries composed primarily of high-technology subsector industries. Over the long-term prime contractors may be impacted as well.

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Direct offsets are of particular interest to the Department. After an infrastructure is created in a purchasing nation, the foreign government is usually committed to sustaining the industry, because of the structural, economic and political implications of losing the jobs associated with the infrastructure. The implication is that the U.S. defense industrial base, particularly subcontractors, may lose market share in the international and U.S. markets as foreign subcontractors become more sophisticated and their governments become more committed to their development.

New competitors to U.S. firms have resulted due to offsets. For example:

- o The Dutch firm DAF is competing for new landing gear contracts with the skills and technology transferred through a coproduction arrangement with the U.S.
- o Kongsberg Vapenfabrikk of Norway is entering the commercial maritime gyrocompass market based on experience and technology transferred by U.S. corporations.
- o The Netherlands, in part through the technology and skills gained through offset agreements is committed to participating in the announced European Fighter Aircraft Program.

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We must keep in mind, however, that the United States requires coproduction for foreign defense systems procured for U.S. forces. Local production of the Italian 9mm sidearm for the Army and the British Harrier aircraft for the Marines are just two recent examples. Through these arrangements the U.S. gains employment, technology and, in some cases, increased competitive benefits which may not have been possible without the U.S. mandated offset agreement.

CONCLUSIONS

There are several general conclusions to be drawn on the effect of offsets on U.S. industrial competitiveness. These are necessarily broad observations, due to the fact that most of the offset obligations incurred by U.S. defense export firms between 1980-1984 have yet to be implemented. Consequently, their full effects cannot yet be analyzed with a high degree of precision. Analysis of the available data and collateral sources supports the following general conclusions:

- o American defense base industries are often obligated to offer offsets in order to participate in and remain competitive in the international marketplace.
- o Offsets are a major factor in the competition for international defense sales, and are being used by foreign

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purchasing governments as a trade management tool for the purposes of preservation of foreign exchange, the targeted development of selected industrial sectors and the enhancement of the capability of domestic industries through technology transfer.

- o Offsets are increasing foreign competition, and may be contributing to the erosion of the U.S. defense base, particularly at the subcontractor level. However, without offsets U.S. industry faces the prospect of losing business to our free world competitors, with all the associated immediate deleterious consequences.
- o While offset related sales of defense systems contribute to the marginal income of defense firms, they are not the principal determinant providing for the health of the U.S. defense base. In fact, the health of the industry depends upon U.S. government purchases.

The Department believes there is a need for a more detailed analysis of the competitiveness impacts of offsets on the U.S. defense industrial base, particularly at the subcontractor level. The report provided to the Committee was macro in its approach and did not focus on an indepth sectoral analysis of this issue.

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The GAO Report on Offsets

The General Accounting Office recently completed their analysis of the interagency study on trade offsets. The briefing report highlights a number of issues of contention with the overall study, the survey instrument and the data collected. Interagency disagreements with the study were also discussed.

The DPA interagency study team is composed of a diverse membership who actively represented their respective agency viewpoints throughout the reporting process. It has been my experience that, with any study of this scope, there will be a number of technical and methodological disagreements among the various participants. These must be resolved by the coordinating agency. In this study, OMB had the difficult job of bringing together all of the inputs and editing material submitted by each agency. The final report reflects what OMB considers to be a fair treatment of this subject.

That concludes my statement, Mr. Chairman. I would be happy to answer any questions you may have.